AF4 2023/2024
Practical issues
Part 2 Investment Strategies

This part will cover the high-level strategies an adviser and the client could use.

The milestones are:

To understand how the following strategies can be used together with their advantages and disadvantages.

- Buy and hold
- Growth v Value strategy
- Contrarian v Momentum investing
- Active v Passive investing
- Core and Satellite strategy
- The difference between going short and long
- Environmental, Social and Governance

Investment Strategies

A strategy is defined as a long-term plan that the advisor considers has the best chance to meet the client's objectives. It isn't set in stone and **tactical decisions** can be made to change it in the short term to meet changing economic conditions.

The strategy must be reconsidered if there is a change in the client's objectives. The most common example will be if the client switches from the accumulation to a decumulation objective.

It is also important to note that the different strategies are not mutually exclusive. It's possible and advisable to have a number of strategies at the same time. They can be used by individuals as well as fund managers.

The Long Haul

Equity markets tend to reward patient investors. There will be day to day volatility but as discussed in an earlier part, over the long term the gains should outweigh the losses. Moreover, the long-term investor benefits from dividend payments.

This strategy is called **Buy and Hold**. Investments are purchased with the intention that they are not touched for many years and can be used by individuals or fund managers.

Its main benefits are:

- Low cost/low admin
- Dividend stream should increase return over long term.

If the portfolio consists of mainly directly held shares

- It may not be possible to get a large enough diversification.
- Few companies survive for long term. There are fewer than 30 companies that have stayed continuously in the FTSE 100 since it was set up in 1984.
- Investors may miss new opportunities as they avoid switching holdings
- Take-overs or mergers may involve holding being absorbed into a different business.

If the portfolio is mainly fund based:

- The manager may be changed and performance may deteriorate.
- The investment style/strategy may change exposing clients to a different level of risk.

This strategy may mot be appropriate for someone later in their life where there is a shorter time horizon to recover any short term losses or if they plan to run down the fund.

Growth or Value Investing

As we saw when we looked at shares, individual stocks can be classed as either growth or value oriented. Investors whether individual or fund managers can adopt a growth or value strategy by buying primarily growth or value stocks.

The classic **growth company** aims to go from a small up and coming business to becoming leaders in their respective field. In their early stages these companies focus on building their revenues rather than profits and only later move to maximising profits. They often build up a dominant market position, acquiring rivals on the way.

They tend to have high valuation as measured by price/earnings ratio but they have a higher growth in revenue than their rivals.

A **value** stock trades at relatively cheap valuations relative to its earnings and long-term growth potential. They tend to have steady predictable business models that generate modest growth in revenue and profits.

Individuals or fund managers adopting a growth strategy will obviously hold growth stocks and this will appeal to investors who:

- Are not concerned about receiving dividends
- Are looking for rapid capital growth.

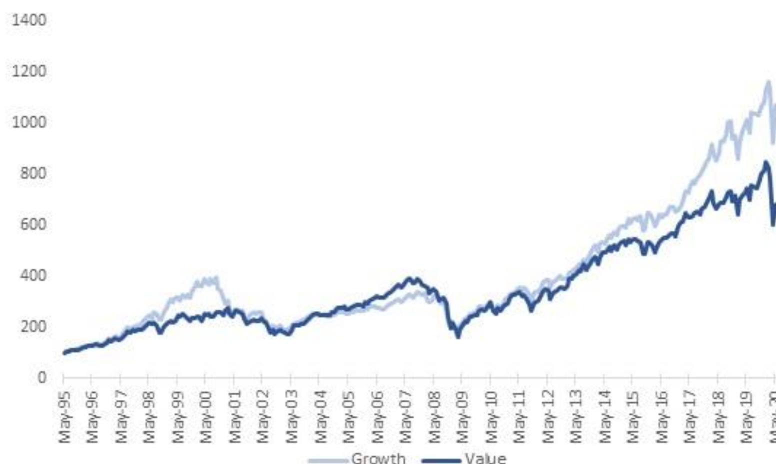
- Are comfortable with a high level of volatility in the share price.
- Feel they can pick out winners in emerging markets
- Possibly have a shorter time horizon

A Value style will appeal to investors who:

- Want a steady flow of dividends
- Prefer to have a lower volatility in the share price.
- Believe they or the fund manager can differentiate between a company that is undervalued but has good prospects and one that is failing with poor prospects of recovery.
- Have a longer time horizon.

Which is better?

According to Brewer Dolphin, value funds have returned 624% since 1995 to 2020 whereas growth funds have returned 1,072% over the same period



The coronavirus pandemic widened the disparity as growth stocks such as the US tech companies massively outperformed the rest of the market. However as we saw in the section on shares these have fallen as interest rates have risen.

Of course, investors can have some funds that are growth oriented and some that take a value approach.

In the long run it is possible that today's growth stocks turn into value ones. A hundred years ago the growth sectors were oil, car manufacturing and radio. There is also the danger that if they achieve an effective monopoly, regulation may break them up.

Finsbury Growth and Income Investment Trust is an example of a combined buy and hold/Growth strategy. According to the Sunday Times, £10,000 invested when it launched in 2001 would be worth £113,745 at the start of 2023. It is reluctant to sell the underlying assets but invests a proportion of it's portfolio in growth sectors that in turn led to a poor performance in 2021 and 2022.

This approach might also be called a **Growth at any reasonable price Strategy.** The manager will consider paying a premium price for stocks with specific advantages or qualities. It mixes value and growth stocks and has a longer term investment horizon.

Contrarian Investing

Like value investing it looks for undervalued stocks but also deliberately goes against current trends. For example, a contrarian fund or investor might in Summer 2020 have invested in travel and leisure companies. The rationale might be that at some point covid restrictions will ease and the share price will revive. It is a high-risk strategy and investors will probably need to be patient and not expect a quick return.

Momentum investing

This follows on from a growth strategy. Investors buy stocks such as Tesla and Amazon whose share price is soaring. Underlying financial data is ignored together with the share valuation. All that matters is that the share price seems to be going in one direction. The danger is that they are buying at the peak and could lose substantial amounts if the price plunges. The share price tends to be very volatile so investors need to be prepared to accept rapid movement up and down and be prepared to hold their position.

The April 2019 paper asked candidates to explain a **deep value investment strategy**

The answer given was:

- Investing for the long term in undervalued stocks
- Where the price is less than the book value of the total assets

In some ways this is a form of contrarian investing. The argument for it is if the company assets are worth considerably more than its market capitalisation there is a reduced risk. This however depends on those assets being realisable and the company has no other debtors who need to be paid before any money can go to the shareholders.

Let’s finish by looking at a couple of quotes. The father of value investing in the US, Benjamin Graham, said

“in the short run the market is like a voting machine-tallying up which firms are popular and unpopular. In the long run the market is like a weighing machine – assessing the substance of a company. What matters in the long run is the company’s actual business performance and not the investing public’s fickle opinion about its prospects in the short run.

Warren Buffet another value investor has said,

“Be fearful when others are greedy and greedy when others are fearful”

Mr Buffet runs Berkshire Hathaway which is the equivalent of a UK investment trust. It is the th 4largest company in the S&P 500. (January 2023) $1,000 dollars invested in 1964 when he took over the company was worth $11.6 million in June 2020

Going short or long

Most investors and fund managers invest long, that is they hope the price of their investments will rise. Hedge funds and some investment managers can go short, that is they hope to make money when prices are falling.
The most common way of doing this is by **stock borrowing.** A hedge fund believes the share price of company is going to fall as in this example It borrows these shares from a pension fund or another institution.

A hedge fund believes shares in ABC plc are going to fall. It approaches a pension fund or other financial institution that owns theses share. The hedge fund asks it can borrow some shares for a fee which benefits the pension fund lending the shares. It will also require the borrower to put up collateral to ensure there is no financial loss if the fund cannot repay the shares.

The hedge fund borrows one million shares in ABC plc from the pension fund. The shares are trading at £2.50 a share. It immediately sells these and receives £2,500,000. The share price falls to £1.50. It then uses the sale proceeds to buy back one million shares for a cost of £1,500,000 and returns the shares to the pension fund.

It has made a profit of £1,000,000 although buying and selling costs together with the fee it paid to the pension fund would reduce this.

Of course, if the shares had risen in price it would make a loss as it would have to spend more than it got from selling the shares in order to give the shares back to the pension fund.

Active or passive investing

An actively managed fund will employ a manager to make run the fund. They will be given a brief on the objectives of the fund and they decide what shares to buy and when they should be sold.

Passive management will use algorithms to replicate the performance of an index. Viewed with some suspicion when they were first launched, they are now form a key part of many portfolios. Almost all major market indices have funds that aim to track them. They can be structured as a unit trust/OEIC or an ETF.

Tracker funds have lower charges than an active one, The Vanguard FTSE 100 Index Unit trust has an **Ongoing Charges Figure (OCF)** of 0.06%.

A fund can use **full replication** buying every share in the index. This can be difficult so two other methods tend to be used;

Stratified sampling

- Shares that are representative of each sector are selected. This may lead to subjective judgements by choosing company A over company B.

Optimisation

- This uses computer modelling to try and broadly replicate the index.

Note that in the April 2019 exam it also gave an option of **synthetic tracking** using derivatives

Funds rarely get exactly the same performance as the index and the difference is called **tracking error** This is expressed as a percentage and the lower this is the closer the fund performance will be to the market performance.

Apart from lower costs the main attraction is that it does what it says on the tin, it delivers the market performance. An active fund can deliver a better performance but it might produce a poorer one.

Most indices are market weighted. The FTSE 100 is effectively a league table with a share's position being based on its market capitalisation. A tracker fund based on that index will have most of its investments in the top 10 shares which can lead to an unbalanced fund.

There are tracker funds available for all the main indicies and the performance will depend on the underlying stocks. The FTSE 100 unperformed most other indices up to 2022 as it was dominated by older companies The S&P in 2022 was heavily dominated by tech companies and had spectacular growth on the back of those figures. However as noted in the section on shares these suffered heavy falls in 2022 and as a result it fell 19.4% in 2022

<u>Advantages</u>

- Lower costs than actively managed fund.
- Analysis tends to show that few active managers consistently outperform the index
- No risk of being the worst performer
- Takes away the risk of choosing the wrong manager
- It is a type of growth investing as companies grow and move up the table, it becomes a greater part of the holding. If a company's share price falls and it moves down the rankings decline it becomes a smaller part of the fund.

<u>Disadvantages</u>

- The fund follows the index so it must reduce its holding in a company that is falling down the rankings even if the long term prospects are good. Similarly it must increase its holding in companies whose price is going up relative to other constituents in the index even though it is felt that this increase is unjustified.

- There must be a representative index which may not be available in some emerging markets.
- The FTSE 100 is top heavy in that 10 companies make up 50% of the index.
- It will not lie on the efficient frontier since it only takes into account market capitalisation.
- It is unlikely to be the best performing fund
- It can never replicate the index because charges will be made although on the other hand an index does not include dividends. The degree of tracking error is therefore a critical factor in assessing the performance of a fund.

Index funds in the US are estimated to make up 45% to 50% of the market share in pooled funds and this domination can create problems.

When investors invest in a tracker fund it will buy proportionally more of the heavily weighted shares which pushes up the price which increases the value of the tracker fund and attracts more new investors. This might be classed as a bubble!

The efficient market hypothesis

One of the points that underpin index tracking is that a mature market such as London is an **efficient market**. This means that:

- All information about securities is already reflected in their prices.
- Any increase or fall in an individual price is random and cannot be predicted.
- Securities respond immediately and rationally to publicly available price sensitive information and move independently of past trends.

The efficient market hypothesis (EMH) has been further developed into three subgroups:

<u>Weak form efficiency</u>

- This holds that no excess returns can be earned by using data based on historical prices or returns.
- Current prices reflect all stock market information.
- However fundamental analysis of a company's financial statements can identify under or over-valued companies.

<u>Semi strong efficiency</u>

- This holds that share prices adjust rapidly to all public information.
- Therefore fundamental analysis will not identify over or undervaluation

Strong form efficiency

- This holds that share prices reflect all information, public and private, and no one can earn excess returns.

How valid is EMH?

- Research shows that a "buy and hold" strategy tends to outperform buying and selling based on trading rules. This tends to support the weak-form hypothesis.
- EMH assumes that all information is available to all participants but automated trading is the main driver of most major markets and getting information a fraction of a second earlier than a competitor can give the firm a competitive edge.
- EMH can only work in a developed and mature market such as London or New York. It doesn't seem to work as well in a developing market.
- The EMH does not square with bubbles and crashes. If the price of a share reflects all known information why are there rapid rises and falls with no additional information being given to the market?

What effect does EMH have on portfolio construction?

- Technical analysis based on past performance will not lead to outperformance after transaction fees.
- Fundamental (company) analysis can lead to identification of over or undervaluation but EMH suggests that this is of limited use as prices will react quickly to news.
- Tracker funds should be used at least as part of a portfolio
- Where a non-tracker fund is used, the portfolio should be diversified and reflect the client's risk profile. It should also minimise transaction and tax costs.

Smart beta

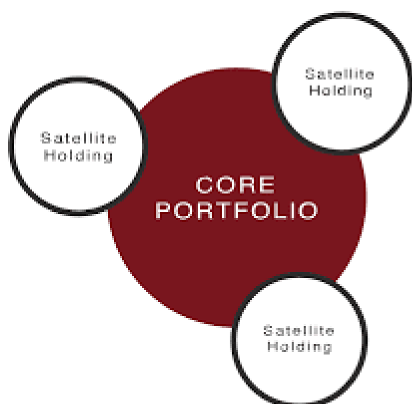
As we know beta measures the volatility of a security against an appropriate index which is deemed to have a beta of 1. It follows that investing in a tracker fund will deliver a beta of 1 although there will probably be an element of tracking error.

A fund that has a smart beta strategy won’t solely rely of the market capitalisation of a stock to determine its weighting in the portfolio. It will consider other factors that could give a greater return for one stock over another. These could include companies that :

- are producing superior profits.
- with strong balance sheets.
- have stable cash flows.

Unlike having a passive strategy it can give a greater weighting to small cap stocks if they meet the manager’s criteria.

Core and Satellite



Following on from this there is a compromise between active and passive management which is a **core and satellite** strategy. Here a core holding is held in passive funds to deliver market returns. This might be split into a range of funds tracking the main indices (e.g.UK, US, Japan)
These will deliver market returns but around this there are specialist funds or possibly directly held shares that aim to give a higher than market return

Environmental, Social and Governance investing

What we used to call ethical investing.

This selects shares that meets set criteria in each of the three parameters.

Environmental criteria might include the company's energy use, waste, pollution, natural resource conservation and treatment of animals. It might consider if the company is campaigning against proposed environmental regulations.

Social criteria looks at issues such as a company's employment policies. Is it subcontracting work to low wage countries?

Governance criteria looks at issues as whether the company uses open and transparent accounting procedures. This should help prevent them engaging in illegal practices or making significant donations to lobby groups that helps the firm get political influence.

It's unlikely that any company would meet all the criteria so an ESG fund would have to select its own standards.

It could adopt a negative approach. This involves identifying companies or sectors that will be avoided. The usual ones are companies involved in tobacco, alcohol, armaments and gambling. Other funds may have stricter criteria.

Positive screening involves identifying companies that meet the fund's ethical criteria and/or attempting to engage with the company to improve their ethical stance.

The traditional view of ethical investing was that it would produce lower returns as it excluded companies with a strong profit performance. Some would argue that if we are moving into a no carbon greener economy, companies with a high ESG score could become the top performers.

One final point to note. Marketing teams in investment firms come up with new strategies all the time. It's important that you keep abreast of new developments by reading the financial press.

That concludes this part so you should now understand:

- Buy and hold
- Growth v Value strategy
- Contrarian v Momentum investing
- Active v Passive investing
- Core and Satellite strategy
- The difference between going short and long
- Environmental, Social and Governance